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SUPREME COURT, U. S.
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Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

BERNARD P. McDONOUGH, Petitioner

v.

JOHN BERSHAD, Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioner, Bernard P. McDonough, respectfully prays for the issuance of a Writ of Certiorari to review the opinion and judgment of the United States Court of Appeals for the Seventh Circuit entered in the above captioned case on June 11, 1969.

OPINIONS BELOW

The opinion of the United States District Court for the Northern District of Illinois, Eastern Division, is reported at 300 F. Supp. 1051 and is appended hereto (Appendix A). The opinion and judgment of the United States Court of Appeals for the Seventh Circuit is unreported as of the date of this petition. That Court's opinion is also appealed hereto (Appendix B).

JURISDICTION

The judgment of the Court of Appeals was entered on June 11, 1969. A timely petition for rehearing was denied by the court on August 5, 1970 (Appendix C). The jurisdiction of this court is invoked under the provisions of 28 U.S.C. 1254 (1).

The alleged basis for federal jurisdiction in the District Court was Section 16(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78 p(b)], which petitioner has challenged for respondent's failure to comply with jurisdictional requirements of the Act and which is discussed hereinafter.

QUESTIONS PRESENTED

1. Whether the suit should be dismissed for lack of jurisdiction because of the failure to allege and prove compliance with the jurisdictional requirements of the statute, Section 16(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78p(b)], under which the action was brought.

2. Whether the decision of the court below is in conflict with this Court's decision in Blau v. Lehman, 368 U.S. 403 (1962).

3. Whether liability under Section 16(b) of the Act can ever be imposed on a person who is not a director, officer or ten percent owner of the corporation or a party to the suit.

4. Whether the court below has so far sanctioned a departure by a lower court from the accepted and usual course of judicial proceedings as to call for the exercise of this Court's power of supervision.

STATUTE INVOLVED

The Securities Exchange Act of 1934, 15 U.S.C. § 78p(b):

* * * * * * *

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or

the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

* * * * * * *

STATEMENT OF THE CASE

On March 16 and 17, 1967, Bernard P. McDonough, on his own behalf, purchased at private sale 141,363 shares of the common stock of Cudahy Company, and on the same dates, as attorney in fact for Alma McDonough, but with her own funds, purchased an identical number of shares for Alma McDonough. (26a)

Following the purchase of the stock by each of the McDonoughs, Bernard P. McDonough was elected to the Board of Directors and named Chairman of the Board and remained chairman until his resignation on July 18, 1967, and remained a director until his resignation on July 25, 1967. (27a)

On July 20, 1967, Bernard P. McDonough and Alma McDonough, each as the owner of certain of the common stock of Cudahy, entered into an option agreement with representatives of United States Smelting, Refining and Mining Company (hereafter Smelting), which granted to Smelting the right, until October 1, 1967, to purchase 272,000 shares of the common stock of Cudahy. The consideration paid for the option was $350,000.00. The price for the optioned stock, in the event of exercise of the option, was set at $9.00 a share, for a total sum of $2,448,000.00. (27a, 30a, 35a, 41a, 54a) In the event the option was exercised by Smelting, the consideration paid for the option was to be applied to the purchase price of the stock. If the option was not exercised, the $350,000.00 was to belong to the McDonoughs. (30a) In addition to the option agreement, there was executed an escrow agreement and proxy, irrevocable until October 1, 1967.

All the agreements between the McDonoughs and Smelting were contained within the four corners of the option agreement and nowhere else.

The evidence was uncontradicted that the parties intended to execute an option; that Smelting sought to obtain an option for the least possible expense; that Smelting had made no decision to buy the stock of Cudahy prior to the execution of the option and that Smelting made no offer to buy the stock in the course of negotiations for the option.

At no time between the date of her purchase of 141,363 shares of the Cudahy stock and the date of the exercise of the option, which was September 22, 1967, was Alma McDonough an officer, director or ten percent shareholder of Cudahy Company.

Between the time the single meeting between the McDonoughs and representatives of Smelting occurred and the date of the execution of the option by Smelting, personnel for Smelting conducted an investigation of the business affairs of Cudahy; reviewed its financial position; analyzed its business and informed themselves generally concerning its prospects in order to gain sufficient information to make a decision as to whether or not the option should be exercised. (54a, 55a, 59a, 61a)

On September 22, 1967, more than six months after the purchase of the stock by either of the McDonoughs and before the termination date of the option, Smelting caused the option to be exercised by directing a letter to the McDonoughs in accordance with the terms of the option agreement notifying them of Smelting's election to exercise the option. (33a, 37a)

In the absence of any evidence, and there was none, that the agreement was other than an option, the District Court held that the transaction between the McDonoughs and Smelting amounted to a sale or contract of sale within the scope of 16(b) of the Act and that such sale or contract of sale took place less than six months after the purchases, resulting in a liability of $612,000.00, together with interest and costs. Judgment was entered June 26, 1969, with interest thereon from July 20, 1967 making a total judgment of $692,380.00 and costs.

Affirming the District Court's decision, the Court below held that the option was a sale within 16(b) of the Act.

REASONS FOR GRANTING THE WRIT

The action should have been dismissed for lack of jurisdiction, as the respondent failed to allege or prove facts showing compliance with the jurisdictional requirements of Section 16(b) of the Securities Exchange Act of 1934.

The court below has decided a federal question in a way which is in conflict with applicable decisions of this Court and in conflict with decisions of other United States Courts of Appeal and has so far sanctioned the departure by a lower court from the accepted and usual course of judicial proceedings as to call for the exercise of this Court's power of supervision.

The court below has construed Section 16(b) in such a manner as to include an option along with a "purchase and sale" greatly enlarging its scope contrary to *Blau v. Lehman,* 368 U.S. 403 (1962).

The court below has approved a judgment which deprives a person not a party to the action and not subject to the extraordinary liability imposed by Section 16(b) of property, contrary to the accepted and usual course of judicial proceedings.

1. The Court lacked jurisdiction to entertain the suit as the plaintiff failed to allege or prove facts showing compliance with the jurisdictional requirements of Section 16(b) of the Securities and Exchange Act of 1934 [15 U.S.C. 78 p (b)] and the suit should be dismissed.

Section 16(b) provides that "Suit to recover such profit may be instituted . . . in any court of competent

jurisdiction by the *issuer*, or by the owner of any security of the issuer in the name and in behalf of the issuer *if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter . . .*" (Emphasis supplied)

Section 16(b) authorized a stockholder to institute an action for "short swing" profits only when the corporation fails to take appropriate action within sixty days after request. Plaintiff did not allege or prove that he made a demand of Cudahy (the issuer) which was rejected and thereafter waited sixty days before bringing the action. Instead he alleged in his Complaint (23A) that such a demand was unnecessary and would be futile. These allegations were denied in the petitioner's Answer (23A) and also in Cudahy's Answer and plaintiff did not produce proof to show compliance with the statute. Under the circumstances, the suit was unauthorized and should be dismissed.

In *McNutt v. General Motors Acceptance Corp.*, 298 U.S. 178 (1936), this Court, through Chief Justice Hughes, reiterated the salutory rule that a Federal District Court must always look to its jurisdiction at any stage of the proceedings and ordered the suit dismissed for failure to allege and prove jurisdiction, stating at page 189:

> "* * * The prerequisites to the exercise of jurisdiction are specifically defined and the plain import of the statute is that the District Court is vested with authority to inquire at any time whether these conditions have been met. They are conditions which must be met by the party who seeks the exercise of jurisdiction in his favor. He

must allege in his pleadings the facts essential to show jurisdiction * * *."

This Court continued at page 190:

"Here the allegation in the bill of complaint as to jurisdictional amount was traversed by the answer. The court made no adequate finding upon that issue of fact, and the record contains no evidence to support the allegation of the bill. There was thus no showing that the District Court had jurisdiction and the bill should have been dismissed upon the ground."

The decree rendered by a three-judge District Court was reversed and the cause remanded with directions to dismiss the bill of complaint for want of jurisdiction.

It is, of course, well settled that a Federal District Court possesses only such jurisdiction as has been conferred by statute, U. S. Constitution, Art. III, *Lockerty v. Phillips*, 319 U.S. 182 (1943); that lack of jurisdiction cannot be waived or overcome by agreement of the parties, *Mitchell v. Maurer*, 293 U.S. 237 (1934) and that the question of jurisdiction is one which can be raised by answer, motion, plea or in any other appropriate manner and which the court is bound to ask and answer for itself, even when not otherwise suggested. *McNutt v. General Motors Acceptance Corp., supra; Clark v. Paul Gray, Inc.*, 306 U.S. 583 (1939); *St. Paul Mercury Ind. Co., v. Red Cab Co.*, 303 U.S. 283 (1938).

2. The decision of the court below conflicts with this Court's decision in Blau v. Lehman.

In *Blau v. Lehman*, 368 U.S. 403 (1962), this Court rejected an effort to broaden the categories of persons

on whom Section 16(b) liabilities were to be imposed. This Court stated that Congress is the proper agency to change an interpretation of the Act "unbroken since its passage," if the change is to be made.

The Court below has construed Section 16(b) in such a manner as to include an option along with a "purchase and sale" and has sanctioned a much greater enlargement of the scope of Section 16(b) than that which was proposed in *Blau v. Lehman*, supra.

Options which are clearly distinguishable from sales have not been held to be sales within the statutory language of "purchase and sale", as used in Section 16(b), *supra*. *Silverman v. Landa*, 200 F. Supp. 193, *aff'd* 306 F.2d 422 (2d Cir. 1962); *Miller v. General Outdoor Advertising Co., et al.*, 223 F. Supp. 790, *rev'd on other grounds* 337 F.2d 944 (2d Cir. 1964); *Blau v. Ogsbury*, 210 F.2d 426 (2d Cir. 1954); *Stella v. Graham-Paige Motor Corp.*, 132 F. Supp. 100, *rev'd on other grounds* 232 F.2d 299 (2d Cir 1956); *Shaw v. Dreyfus*, 79 F. Supp. 533, *aff'd* 172 F.2d 140 (2d Cir. 1949). But if options are to be included by judicial construction as in this case, then a multiplicity of suits without congressional sanction based on various theories of Section 16(b) liability will result.

Nothing in Section 16(b), or the legislative history as exhaustively treated by this Court in *Blau v. Lehman, supra*, remotely suggests that Congress intended to add an "option" or alter the six-month period as the Court below has done. Congress has not seen fit to include "option" in the Act or shorten the six-month period since enactment of the original Act in 1934. Yet the Court below has done precisely that by adopting as

the law the respondent's unproven theory that the option constituted a sale absent any evidence to that effect.

In order for the Court of Appeals to adopt the decision of the District Judge, it was necessary that it ignore the option agreement; the uncontradicted testimony of the parties thereto that an option was intended; the uncontradicted testimony that Smelting sought an option for as cheap a price as possible (55a), and that the purpose of the option was to give Smelting an opportunity to study the operations and financial condition of Cudahy (59a, 60a). The decision of the Court of Appeals must have been premised upon the affidavit of the attorney for the plaintiff which was admittedly made without personal knowledge and was argumentative rather than factual.

The hypothetical case referred to by the District Judge in his opinion (10a), in which the holder of an "option" pay the "optioner" $900,000.00 for an option to buy certain securities for $1,000,000.00 within a set time hardly reaches this case for obvious reasons. The acid test which the District Court could have applied, but did not, in ruling that the option agreement was a sale when made, is whether the McDonoughs could have compelled Smelting to purchase the stock and pay the $2,098,000.00 purchase price if Smelting did not exercise the option before its expiration. The obvious answer appears to be "no". We doubt if there is a Federal District Court in the country which would compel payment under such an agreement.

The $350,000.00 consideration paid was $126,000.00 less than it would have cost Smelting to pay for such an option on the market, as 90-day calls on Cudahy

common stock at the market price in July, 1967, was $1.97 per share or $476,000.00 for 272,000 shares.

Only by resorting to speculation and conjecture could Judge Marowitz have found that the option was a sale, and the long-standing rule applied by this Court and uniformly followed by most Federal District and Appellate Courts is that speculation and conjecture will not support a judgment. *Pennsylvania R.R. Co. v. Chamberlain*, 288 U.S. 333 (1933). This well-settled principle should not be abrogated in a Section 16(b) case simply to invoke the forfeiture of the statute.

The interest allowed was inconsistent with the principle involved in *Blau v. Lehman, supra*, that when the statute does not provide for interest, as in this case, interest is not recovered according to a rigid theory of compensation for money withheld, but is given in response to considerations of fairness. It is denied when its exaction would be inequitable. Here, the allowance of interest in the amount of $70,390.00 was unfair and inequitable and in Alma McDonough's case clearly error, exacting as it does interest based upon the shares she owned separately and assessing the penalty against Bernard P. McDonough.

3. The decision of the court below affirming the judgment of the trial court has sanctioned a departure from accepted procedures in allowing a recovery on Alma McDonough's profits although she was not a party to the suit and holding Bernard P. McDonough to be liable for such profits.

In *Blau v. Lehman*, 368 U.S. 403 (1962), this Court held that neither the statute nor the policy underlying the enactment of Section 16(b) permits an expansion

of the statute's scope to persons other than directors, officers and ten percent shareholders. The Court stated therein at page 409:

> "The language of §16 does not purport to impose its extraordinary liability on any 'person,' • • unless he or it is a 'director,' 'officer,' or 'beneficial owner' of more than 10 per centum • • •."

Alma McDonough did not fall within any of these categories as she was not a director, an officer or a ten percent shareholder. Her personal assets were used to purchase the 141,363 shares she owned. (35a) She does not come within the purview of the statute. She was not a party to the action and the lower court clearly erred in imposing liability on her under the statute where none existed and holding Bernard P. McDonough liable for his wife's profits which she received in her own name and right. Certainly nothing in Section 16 (b), *supra*, would sanction or permit the unusual procedure followed by the trial judge of allowing a recovery on the stock of a person not a party to the suit on some unexplained theory that such person had in some way forfeited her profits under Section 16(b) even though she clearly did not come under the Act and was not subject to the forfeiture provisions thereof. Manifestly there is no authority in the statute or under the law which would justify the taking or confiscation of Mrs. McDonough's property under such a procedure. The judgment insofar as it levies against Mrs. McDonough's stock and declares a forfeiture of her profits amounting to $306,000.00, does violence to the due process provisions of the Constitution and the judicial process generally.

Although the statute has been in effect since 1934 and has been the subject of much litigation, there do not appear to be any cases in which Section 16(b) liability has been imposed upon a person in Alma McDonough's position who was not a director, officer or ten percent shareholder, or a party to the suit, and we respectfully submit that judgment should be reversed to avoid this obvious error and prevent this miscarriage of justice.

4. The decision below is in conflict with the opinions of other circuits construing Section 16(b).

The court below recognized the division amongst the various circuits in construing Section 16(b), one group applying the harsh automatic or "rule of thumb" test,[1] and the other group, the more liberal or "pragmatic" test,[2] in determining Section 16(b) liability but did not subscribe to either test. The Court Appeals instead fashioned a rule of its own which was a mixture of the two tests and affirmed the District Court's decision, which was predicated on speculation and conjecture. This it is submitted only further compounded the confusion which exists between the various circuits and demonstrates the acute need for a clarifying decision by this Court in this case.

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1. *Park & Tilford, Inc. v. Schulte,* 160 F.2d 984 (2d Cir.), cert. denied 332 U. S. 761 (1947); *Smolowe v. Delando Corp.,* 136 F.2d 231, 235 (2d Cir.), cert. denied 320 U.S. 751 (1943); *Heli-Coil Corp. v. Webster,* 352 F.2d 156 (3d Cir. 1965).

2. *Blau v. Lamb,* 363 F.2d 507 (2d Cir. 1966), cert. denied 385 U.S. 1002 (1967); *Petteys v. Butler,* 367 F.2d 528 (8th Cir.), cert. denied 385 U.S. 1006 (1967).

The decision below is in conflict with those opinions applying the "rule of thumb test" referred to above and cited in footnote 1, for if the rule of thumb test was applied fairly to this case, the record is clear that the option was exercised after the six-month period and the coverage of Section 16(b) is confined to a six-month period.

The decision below is also in conflict with *Heli-Coil Corp. v. Webster,* 352 F.2d 156 (3d Cir. 1965), another rule of thumb case in which it was held that under Section 16(b) the statutory liability applies only to "profit realized by" a "director or officer or ten per cent stockholder" from "any purchase and sale * * * within any period of less than six months" and the record is clear that the profit was realized after the six-month period.

CONCLUSION

For the foregoing reasons, the petition for certiorari should be granted.

THOMAS E. WALSH
HERBERT G. UNDERWOOD
Attorneys for Petitioner

October, 1970

APPENDIX A

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JOHN BERSHAD,
Plaintiff,
v.
BERNARD P. McDONOUGH and CUDAHY COMPANY,
Defendants.

No. 68 C 2038

Memorandum Opinion

Cross-Motions for Summary Judgment

Pursuant to Section 16(b) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. § 78(p)(b), this action is brought by John Bershad, owner of certain of the common stock of defendant Cudahy Company (Cudahy) to recover for the benefit of Cudahy the purported "short swing" profits accruing to the defendant Bernard P. McDonough from the alleged purchase by him and sale to United States Smelting, Refining and Mining Company (Smelting) of 272,000 shares of the common stock of Cudahy within a period of less than six months. In part, Section 16(b) reads as follows:

> "(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized

by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months."

Both sides have moved for summary judgment.

The essential facts in this case are undisputed. Cudahy is a Maine corporation whose common stock at all pertinent times was registered and traded on the New York Stock Exchange and not an exempted security under Section 3(a)(12) of the Act, 15 U.S.C. § 78a(12). On March 15 and 16, 1967, Bernard P. McDonough purchased 141,363 shares of common stock of Cudahy from Continential Illinois National Bank and Trust Company of Chicago, which was acting as Executor of the Estate of Edward A. Cudahy. On the same date McDonough, as attorney in fact for Alma McDonough, purchased at a like sale for Alma McDonough 141,363 shares of Cudahy common stock. These purchases were made at a price of $6.75 per share. About two weeks later, on April 4, 1967, Bernard P. McDonough, Donald E. Martin, Carl L. Broughton and Otto Gressens were elected directors of Cudahy.

Thereafter, on July 20, 1967, Bernard P. and Alma McDonough each owners of 141,363 shares of the common stock of Cudahy, executed an agreement entitled

"Option Agreement" with Smelting, a copy of which agreement is attached to the respective affidavits of the McDonoughs as "Affiant's Exhibit No. 1." At the same time that the option agreement was executed, the Mcdonoughs executed an escrow agreement, a copy of which is attached to both the respective McDonough affidavits as "Affiant's Exhibit No. 2." Also on July 20, 1967, the McDonoughs executed and delivered to Jack Wilder, President of Smelting, a proxy, a copy of which is attached as "Affiant's Exhibit No. 3" to the respective McDonough affidavits. All of the negotiations which resulted in the execution of the option agreement, escrow agreement and proxy took place in Wood County, West Virginia, on July 20, 1967.

Bernard P. McDonough resigned as an officer of Cudahy on July 18, 1967, and as a director of Cudahy on July 25, 1967. Those persons who were elected with McDonough as Cudahy directors on April 4, 1967, resigned as well. On July 28, 1967, these positions on Cudahy's Board of Directors were filled by persons with strong ties to Smelting, including Martin Horwitz, then Chairman of the Board of Directors of Smelting, and Jack Wilder, then president and a director of Smelting.

Under the Option Agreement, Smelting paid $350,000.00 to the McDonoughs for an option to purchase 272,000 shares of Cudahy common at a price of $9.00 a share on or before October 1, 1967. While the $350,000.00 belonged to the McDonoughs absolutely if the option were not exercised, the money was to be applied against the $2,448,000.00 purchase price if the option to buy the stock were exercised. Under the proxy agreement, the McDonoughs granted Smelting a proxy, irrevocable until

October 1, 1967, to vote the 272,000 common shares of Cudahy. Following the execution of the option agreement, escrow agreement and proxy, certificates representing 272,000 shares of the common stock of Cudahy were delivered to Ralph Bohannon, which certificates remained in his possession in Clarksburg, West Virginia, until September 27, 1967.

On September 22, 1967, Martin Horwitz, then Chairman of the Board of Smelting, directed a letter to the McDonoughs notifying them of the exercise by Smelting of its option to purchase the 272,000 shares of Cudahy common stock. Five days later, at Parkersburg, West Virginia, delivery of certificates representing the 272,000 shares was made to Robert Pirie, who represented himself to be an attorney for Smelting. At the time of the delivery to Pirie, Bohannon, on behalf of the McDonoughs, received a check in the amount of $2,098,000.00 from Pirie.

From this relatively simple set of facts, the respective parties ask us to draw opposing conclusions. Defendants contend that what took place was the granting of an option which was not exercised and therefore did not mature into a sale of stock until more than six months after the stock was originally purchased by the McDonoughs. Plaintiffs, on the other hand, suggest that the transactions between the McDonoughs and Smelting constituted a sale or contract to sell within the meaning of the statute.

Initially, it is clear that the law has drawn a distinction between an option and a sale. The pure option contract is one by which the owner of property agrees with another person that the latter shall have the right

to buy the former's property at a fixed price within a fixed time. *Graney v. United States,* 258 F. Supp. 383, 386 (S.D. W.Va. 1966), aff'd. 377 F.2d 992 (4th Cir. 1967); *Whitelaw v. Brady,* 3 Ill.2d 583, 588-89 (1954). For a price, the optionee purchases the right to choose to conclude or not to conclude a particular transaction. For example, in *Silverman v. Landa,* 306 F.2d 422 (2d Cir. 1962), which was an action to recover "short swing" profits allegedly accruing the result of violation of Section 16(b) of the Act, the optionee paid a premium of $4,000 for the right to buy 1,000 shares of stock at the market price (24⅜ per share) on the date that the option was granted.

In the pure option agreement, "(w)hile the option extends the right to purchase, it imposes no binding obligation to do so on the person holding the option." *Graney v. United States,* 258 F. Supp. 383, 386 (S.D. W.Va, 1966), aff'd, 377 F.2d (4th Cir. 1967). Discussing such an agreement in relation to Section 16(b), the Second Circuit has said:

> "By its nature, the option is one-sided; it fixes the obligations, but not the rights, of the issuer. Landa cannot be said to have 'sold' or 'purchased' Fruehauf stock; should the options lapse unexercised (and in fact the call options did so lapse), no change in his beneficial ownership of the underlying security would occur. And, most importantly, any change would occur at the pleasure of the optionee. Only if both the options had been exercised within their first six months would there have been a 'sale and purchase' of the underlying security within the reach of § 16(b)."

Silverman v. Landa, 306 F.2d 422, 424 (2d Cir. 1962). See also, *Stella v. Graham-Paige Motors Corp.,* 232 F.2d 299, 301 (2d Cir. 1956); *Blau v. Ogsbury,* 210 F.2d 426 (2d Cir. 1954); *Shaw v. Dreyfus,* 79 F. Supp. 533 (S.D. N.Y. 1948).

At the same time, in securities law as in other areas, things are not always what they seem to be. Recognizing this, the judiciary has recently shifted away from an objective, mechanistic interpretation of the security statutes toward a more subjective, pragmatic approach designed to deal with the particular facts of a case in light of the purpose of the relevant statutory section. Lowenfels, "Section 16(b): A New Trend in Regulating Insider "Trading," 54 Cornell L. Rev. 45, 50-57 (1968). In a recent Section 10(b) matter, the Supreme Court said the real questions to be asked in securities cases were whether the defendant's conduct was that type of behavior meant to be forbidden by the law and whether the broad purposes of the securities laws would be furthered by an application to the situation under review. *SEC v. National Sec ities, Inc.,* 393 U.S. 453, 467 (1969). Such an approach had already been invoked in a suit, similar to the instant action, to recover short-swing profits. In *Blau v. Lamb,* 363 F.2d 507, 516 (9th Cir. 1966), The Ninth Circuit noted that the scope of Section 16(b) was extensive, reaching every transaction, including options, "that might possibly permit an insider to use information unfairly . . . ." The application of Section 16(b) in a particular situation consequently "depends upon whether the transaction in question could tend to accomplish what the section was designed to protect." *Id.* at 519. In brief, we are concerned more with substance than form.

It is plaintiff's contenion that this case involves more than a pure option by virtue of the substantial down payment which was to be credited against the purchase price, the grant of the irrevocable proxy, and the resignations of McDonough and associates. Unlike the situation in *Silverman v. Landa, supra,* the money paid to the McDonoughs for the right to purchase Cudahy stock was not a premium, but was to be credited to the purchase price if the option to buy were exercised. To make the simple generalization that all such arrangements, regardless of the extent of the potential credit, fall outside the scope of Section 16(b) would open the door for flagrant violations of this remedial law. If, for instance, the holder of an "option" pays the "optionor" $900,000 for an "option" to buy certain securities for $1,000,000 within a set time, and that payment is to be credited to the sale price upon exercise of the "option," it could hardly be said, from a practical business viewpoint, that the "optionee" was not irrevocably bound to exercise his "option" and technically conclude the sale. A substantial down payment is, in reality, tantamount to a sale.

As this case presents a rather novel question, and there is no direct precedent to guide us in determining how substantial a down payment must be in order to be characterized as equivalent to a sale, we must resolve the issue "in a manner that is practical and logical and will be most consonant with the statutory purpose." *Booth v. Varian Associates,* 334 F.2d 1, 4 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965). The down payment paid by Smelting was $350,000. This payment amounted to approximately 14% of the total purchase price. In a similar, if not identical situation, *Blau v. Allen,* 163

F. Supp. 702 (S.D. N.Y. 1958), two parties agreed that the seller would deliver 800,000 shares of stock if the purchaser paid $2,000,000 within one week, another $10,000,000 two months later, and a final $10,000,000 two months after that. Under the agreement, any payments were to be treated as liquidated damages in the event all payments were not forthcoming. *Id.* at 705. The first payment was made within the required time. The court recognized that the payment, which was 11% of the sales price, "was not just a binder but constituted a substantial portion of the purchase price." *Id.* It then said that if the agremeent was to be considered an option, then it appeared to have been exercised by initial down payment. *Id.* In our case, the down payment was made at the time the agreement was written as opposed to one week later as in *Blau v. Allen.* Yet, under the approach of that case, all that this distinction means is that the "option" herein was exercised immediately by the payment of a substantial portion of the purchase price.

Yet, while speaking in hypotheticals about considering the agreement as an option, the court, in fact, construed the transaction as a sale or, perhaps, a contract to sell which provided for installment payments. Under either view, once a significant payment was made,

> "the buyer would be bound to complete the agreement or suffer the loss of his first payment and the sellers bound to await further payment by the buyer. The rights and obligations of the respective parties had become fixed and there was a sale within the meaning of section 16(b). Citation omitted." *Id.* at 705.

See 2 Loss, Securities Regulation 1099 (2d ed. 1961).

The instant case is much stronger than that of *Blau v. Allen*. In the first place, the down payment is somewhat larger. Second, here, although not in *Blau v. Allen*, the final payment was made, thereby lending credence to the view that a firm sale with a delayed paymented provision was the essence of the agreement. Third, as the McDonoughs insured the success of the sale by requiring a high down payment, Smelting insured that it had the equivalent of a purchase by securing in irrevocable proxy. The resignation of Bernard P. McDonough and others as directors of Cudahy and their replacement by key Smelting officials soon after the execution of the agreement indicates that control of Cudahy passed to Smelting, that a sale, had, in effect, been accomplished.

In conclusion, that defendant McDonough is subject to the provisions of Section 16(b) has not been questioned. *Adler v. Klawans*, 267 F.2d 840, 845-47 (2d Cir. 1959); *Blau v. Allen*, 163 F. Supp. 702, 704 (S.D. N.Y. 1958); see 2 Loss, Securities Regulation 1060-61 (2d ed. 1961). McDonough, in fact, acknowledges that this case turns solely on whether or not the purchase and sale of the Cudahy stock by the McDonoughs occurred within a period of less than six months. (McDonough's Memorandum of Law in Support, at 8.) The resolution of that question depends on whether the sale to Smelting was consummated when the option was exercised by Smelting or when Smelting made a substantial payment to the McDonoughs, received their proxy, and effected a change in the Cudahy Board of Directors. Looking to the substance rather than to the form of the transaction, we are convinced that such an arrange-

ment could serve as a vehicle for the unfair use of inside information leading to unfair profitable insider trading, all of which Section 16(b) was enacted to prohibit. *Blau v. Lamb,* 363 F.2d 507, 516, 518-19 (1966).

We conclude that transaction entered into between the McDonoughs and Smelting amounted to a sale or a contract to sell within the terms of the statute and less than six months after the purchase. Because abuses are made possible, Section 16(b) must be invoked without further inquiry and irrespective of any actual abuse. *Id.* at 516; *Newmark v. R K O General, Inc.,* 294 F. Supp. 358, 362 (S.D. N.Y. 1968). Summary judgment is granted to the plaintiff and denied to defendant.

ENTER: ABRAHAM L. MAROVITZ

Date: June 19, 1969.

APPENDIX B

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

SEPTEMBER TERM, 1969 JANUARY SESSION, 1970

No. 17810
JOHN BERSHAD,
Plaintiff-Appellee,
v.
BERNARD P. McDONOUGH,
Defendant-Appellant.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

JUNE 11, 1970

Before SWYGERT, *Chief Judge,* CUMMINGS, *Circuit Judge,* and GRANT, *District Judge.*[1]

CUMMINGS, *Circuit Judge.* This appeal is from a summary judgment in favor of the plaintiff, a common stockholder in the Cudahy Company of Phoenix Arizona. Plaintiff brought this action under Section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p(b))

1. Chief Judge Grant of the United States District Court for the Northern District of Indiana is sitting by designation.

to recover for Cudahy's benefit the "short-swing" profits coming to defendant from his and his wife's purchase and sale of 272,000 shares of Cudahy common stock.

On March 15 and 16, 1967, defendant Bernard P. McDonough and his wife Alma, who reside in Parkersburg, West Virginia, each purchased 141,363 shares of Cudahy common stock at $6.75 per share, totaling over 10% of the outstanding common stock of Cudahy.[2] Soon after the purchase, McDonough was elected to the Cudahy Board of Directors and named Chairman of the Board.[3] At the same time, Donald E. Martin and Carl Broughton, business associates of McDonough, were elected to the Cudahy Board.

On July 20, 1967, in Parkersburg, West Virginia, Mr. and Mrs. McDonough and Smelting Refining and Mining Co. ("Smelting") entered into a formal "option agreement" granting Smelting the right to purchase 272,000 shares of the McDonoughs' Cudahy stock. Smelting paid $350,000 upon execution of the agreement, which set the purchase price for the shares at $9 per share, or a total of $2,448,000. The option was exercisable on or before October 1, 1967. The $350,000 was to

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2. At all times relevant to this case the stock of Cudahy Company was listed on the New York Stock Exchange.

3. McDonough resigned as chairman on July 18, 1967.

be applied against the purchase price but was to belong to the McDonoughs if Smelting failed to exercise the option. Accompanying this "option" was an escrow agreement under which the McDonoughs' 272,000 shares of Cudahy stock were placed in escrow with their lawyer. They also simultaneously granted Smelting an irrevocable proxy to vote their 272,000 shares of stock until October 1, 1967.

A day or two after the documents were signed, Mr. McDonough and Carl Broughton, his business associate, acceded to the request of Smelting and agreed to resign from the Cudahy Board if Smelting representatives were put on the Board. Both of them resigned as directors on July 25, 1967. About that time, five nominees of Smelting were placed on the Cudahy Board. Smelting subsequently wrote the McDonoughs on September 22, 1967, that it was exercising its option. The closing took place in Parkersburg five days later, with the $2,098,000 balance of the purchase price being paid to the McDonoughs through the escrow agent. From their sales, Mr. and Mrs. McDonough realized a profit of $612,000.

In the court below, defendant contended that under West Virginia law the July 20 agreement constituted an option contract with Smelting, and not a contract for the sale of the Cudahy stock. *Graney v. United States*, 258 F. Supp. 383, 386 (S.D. W.Va. 1966), affirmed *per curiam*, 377 F.2d 992 (4th Cir. 1967), certiorari denied, 389 U.S. 1002. A stock option, he argued, does not qualify as a "sale or contract for sale" for purposes of applying the rule of Section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78p(b)).[4] The district

court, however, took another view of the transaction. In a thoughtful memorandum opinion, the trial judge looked beyond the formal wording of the July 20 "option" and concluded that the transaction between the McDonoughs and Smelting "amounted to a sale or a contract of sale" within the terms of the Securities Exchange Act. Since this event occurred less than six months after the McDonoughs had purchased the Cudahy stock, under Section 16(b) summary judgment for $612,000, together with interest, was entered for plainitff. We affirm.

Section 16(b) was designed to prevent speculation in corporate securities by "insiders" such as directors, officers and large stockholders. Congress intended the statute to curb manipulative and unethical practices which result from the misuse of important corporate in-

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4. In pertinent part, Section 16(b) provides:

"For the purposes of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. * * *" (15 U.S.C. § 78p(b)).

formation for the personal aggrandizement or unfair profit of the insider. Congress hoped to insure the strict observance of the insider's fiduciary duties to outside shareholders and the corporation by removing the profit from short-swing dealings in corporate securities. Conversely, Congress sought to avoid unduly discouraging bona fide long-term contributions to corporate capital. See *Blau v. Lamb*, 363 F.2d 507, 514-516 (2d Cir. 1966), certiorari denied, 385 U.S. 1002; *Petteys v. Butler*, 367 F.2d 528, 532 (8th Cir. 1966), certiorari denied *sub nom. Blau v. Petteys*, 385 U.S. 1006; *Blau v. Max Factor & Co.*, 342 F.2d 304, 308 (9th Cir. 1965), certiorari denied, 382 U.S. 892; *Smolowe v. Delendo*, 136 F.2d 231, 237-239 (2d Cir. 1943), certiorari denied, 320 U.S. 751.

In order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16(b) imposes strict liability upon substantially all transactions occurring within the statutory time period, regardless of the intent of hte insider or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the maximum prophylactic effect. See *Petteys v. Butler, supra*, at pp. 532-533; *Smolowe v. Delendo, supra*, at pp. 236-237; *Blau v. Lamb, supra*, at p. 515. The harshness of the rule was mitigated, however, by confining its coverage to a period of six months, thereby ensuring the minimum adverse effect upon valuable, long-term investments and at the same time facilitating easy and certain compliance with the strictures of Section 16(b). The thrust of the statutory scheme thus placed responsibility for meticulous observance of

the provision upon the shoulders of the insider. He was deemed capable of structuring his dealings to avoid any possibility of taint and therefore must bear the risks of any inadvertent miscalculation. Cf. *Polaroid Corp. v. Casselman,* 213 F. Supp. 379, 382 (S.D. N.Y. 1962); see generally, II Loss, *Securities Regulation,* Ch. 6C, pp. 1040, *et seq.* (2d ed. 1961).

Under Section 3(a)(14) of the Act (15 U.S.C. § 78c (a)(14)), the "sales" covered by Section 16(b) are broadly defined to include "any contract to sell or otherwise dispose of" any security. See *SEC v. National Securities, Inc.,* 393 U.S. 453, 467, n. 8. Construction of these terms is a matter of federal law (see *Tcherepnin v. Knight,* 389 U.S. 332, 337-338; *Blau v. Lehman,* 368 U.S. 403), and "[w]hatever the terms 'purchase' and 'sale' may mean in other contexts," they should be construed in a manner which will effectuate the purposes of the specific section of the Act in which they are used. *SEC v. National Securities, Inc.,* 393 U.S. 453, 467. Applying this touchstone, courts have generally concluded that a transaction falls within the ambit of Section 16(b) if it can reasonably be characterized as a "purchase" or "sale" without doing violence to the language of the statute, and if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b). *Blau v. Lamb,* 363 F.2d 507, 518 (2d Cir. 1966), certiorari denied, 385 U.S. 1002; *Petteys v. Butler,* 367 F.2d 528, 532 (8th Cir. 1966), certiorari denied *sub nom. Blau v. Petteys,* 385 U.S. 1006; *Heli-Coil Corporation v. Webster,* 352 F.2d (3d Cir. 1965); *Blau v. Max Factor & Co.,* 342 F.2d 304, 307 (9th Cir. 1965), certiorari denied, 382 U.S. 892; *Blau v. Lehman,* 286 F.2d 786, 792 (2d Cir. 1960), affirmed, 368

U.S. 403; *Ferraiolo v. Newman*, 259 F.2d 342, 345 (6th Cir. 1958), certiorari denied, 359 U.S. 927.[5]

The phrase "any purchase and sale" in Section 16(b) is therefore not to be limited or defined solely in

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5. The basic principle of the rule has frequently been relied upon by some courts to exclude from liability certain stock conversions which might otherwise be deemed within the coverage of the Section 16(b) prohibition. See generally, II Loss, *Securities Regulation*, Ch. 6C, pp. 1066-1072 (1961), and V Loss, *Securities Regulation*, Ch. 6C, pp. 3031-3040 (Supplement to Vol. II, 1969); see also, L. D. Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 Corn. L.Q. 29 (1968); Note, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act*, 59 Yale L.J. 510 (1950). We do not feel obliged to enter the debate over the "objective" versus "pragmatic" approach which has consumed courts faced with transactions that are apparently "sales" but without risk of speculative abuses and insider profiteering. The "pragmatic" approach has never been extended to immunize transactions in which potential abuses of inside information can be seen. On the other hand, the "objective" or "rule of thumb" approach need not compel a court to wink at the substantial effects of a transaction which is rife with potential sharp practices in order to preserve the easy application of the short-swing provisions under Section 16(b). Certainly the interest of simple application of the prohibitions of Section 16(b) does not carry so far as to facilitate evasion of that provision's function by formalistic devices. Cf. *Newmark v. RKO General, Inc.*, ... F.2d .... (2d Cir. 1970), 38 L.W. 2614.

terms of commercial law of sales and notions of contractual rights and duties. Cf. *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 266 (7th Cir. 1966), certiorari denied *sub nom. Bard v. Dasho*, 389 U.S. 977; *Lawrence v. SEC*, 398 F.2d 276, 280 (1st Cir. 1968); *Vine v. Beneficial Finance Co.*, 374 F.2d 627, 634 (2d Cir. 1967), certiorari denied, 389 U.S. 970. Applicability of this Section may depend upon the factual circumstances of the transaction, the sequence of relevant transactions, and whether the insider is "purchasing" or "selling" the security. Cf. *Blau v. Lamb*, 363 F.2d 507, 523-524 (2d Cir. 1966), certiorari denied, 386 U.S. 1002. By the same token, we conclude transactions subject to speculative abuses deserve careful scrutiny. The insider should not be permitted to speculate with impunity merely by varying the paper form of his transactions. The commercial substance of the transaction rather than its form must be considered, and courts should guard against sham transactions by which an insider disguises the effective transfer of stock. Cf. *Blau v. Allen*, 163 F. Supp. 702, 705-706 (S.D. N.Y. 1958).

The considerations thus guiding the application of Section 16(b) provide substantial support for coverage of an insider's sale of an option within six months of his purchase of the underlying security. The utility of various stock options as a tool of speculation is well

recognized.[6] As noted in *Booth v. Varian Associates*, 334 F.2d 1, 4 (1st Cir. 1964), certiorari denied, 379 U.S. 961:

> "Options, conversions and similar devices have lent themselves quite readily to the abuses uncovered in the Congressional investigation antedating the Act, and in order to give maximum support to the statute courts have attempted to include these transactions by characterizing them as purchases or sales."

The insider's sale of options in his stock is well adapted to speculation and abuse of inside information whether the option is subsequently exercised or not. The sale of the right to purchase the underlying security is itself a means of realizing a profit from that security. The right to purchase stock at a given price under specified cir-

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6. See Note, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act*, 59 Yale L.J. 510, 513-523 (1959); compare Hardee, *Stock Options and the "Insider Trading" Provisions of the Securities Exchange Act*, 65 Harv. L. Rev. 997 (1952) with Cook and Feldman, *Insider Trading Under The Securities Exchange Act*, 66 Harv. L. Rev. 612, 617-624 (1953); see also Comment *Put and Call Options Under Section 16 of the Securities Exchange Act*, 69 Yale L. J. 868 (1960); Michaely & Lee, *Put and Call Options: Criteria for Applicability of Section 16(b) of the Securities Exchange Act of 1934*, 40 Notre Dame Law. 239 (1965). The primary focus has been on the abuses of somewhat different options than present in this case. However, the possible distinctions do not indicate that the insider here may not speculate with the special information he acquires, but only that his ability to maximize his profits from such utilization of inside information is somewhat diminished.

cumstances, although clearly not identical to the rights attendant upon ownership of the stock itself, derives from and is dependent upon the value of the underlying security. Sale of such purchase rights provides an easy vehicle for the use of inside information in extracting profits from the stock itself. Where the option is ultimately exercised, moreover, the exact date of exercise may be unimportant to the substance of the transaction from the point of view of the insider-vendor, since by setting the terms of sale in the option he can exploit his position in the corporation. In addition, parties frequently provide that the option price shall be considered a retroactive down payment of the purchase price of the stock sold upon exercise of the option. Under such circumstances, it may be reasonable to hold the parties to their own treatment of the transaction and date the "sale" of the stock at the purchase of the option rather than its exercise. Cf. *Booth v. Varian Associates,* 334 F.2d 1, 4 (1st Cir. 1964), certiorari denied, 379 U.S. 961; Michaely & Lee, *Put and Call Options: Criteria for Applicability of Section 16(b) of the Securities Exchange Act of 1934,* 40 Notre Dame Law. 239 (1965).

It is unnecessary, however, to rely solely upon these considerations to conclude that the McDonoughs' "sale" of the Cudahy stock to Smelting took place well in advance of the exercise of the option on September 22. The circumstances of the transactions clearly indicate that the stock was effectively transferred, for all practical purposes, long before the exercise of the option. The $350,000 "binder" ostensibly paid for the option represented over 14% of the total purchase price of the stock. Granting the magnitude of the sale contemplated, the size of the initial commitment strongly suggests

that it "was not just a binder." Cf. *Blau v. Allen,* 162 F.Supp. 702, 705 (S.D. N.Y. 1958). The extent of that payment represented, if not the exercise of the option, a significant deterrent to the abandonment of the contemplated sale. In addition, the reverse side of the "Option Agreement" contained provisions for the transfer of the Cudahy stock, endorsed in blank, to an escrow agent pending completion of the transaction. At the same time, the McDonoughs delivered an irrevocable proxy to Smelting to vote the 272,000 shares at any regular or special shareholders' meetings. Within a few days, McDonough and one of his associate directors resigned and were replaced by representatives of Smelting's interests, including the Chairman of the Board of Directors of Smelting, and the president and director of that corporation. Significantly, only a few days after the expiration of the six-month period from the McDonoughs' purchase of the Cudahy stock, Smelting formally exercised its option and, on the same day that Smelting mailed its notification, the McDonoughs executed the necessary stock powers.

Defendant finally contends that these facts were insufficient to support the district court's grant of summary judgment in favor of plaintiff. We cannot accept this contention. The question in this case, unlike *Blau v. Allen,* 163 F.Supp. 702, 705 (S.D. N.Y. 1958), involves the determination not of the existence of the sale, but the date to be ascribed to the transfer under Section 16(b). The basic facts in this case are undisputed and far exceed those present in *Allen.* In light of these facts we conclude that as a matter of law, the sale was effectively accomplished within the six-month period contemplated by Section 16(b). Cf. *Booth v. Varian Associates,* 334

F.2d 1 (1st Cir. 1964), certiorari denied, 379 U.S. 961. Consequently, the motion for summary judgment was properly granted.

AFFIRMED.

A true Copy:

Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

Wednesday, August 5, 1970

Before

HON. LUTHER M. SWYGERT, *Chief Judge*
HON. WALTER J. CUMMINGS, *Circuit Judge*
HON. ROBERT A. GRANT, *District Judge*

No. 17810 JOHN BERSHAD, Plaintiff-Appellee, v. BERNARD P. McDONOUGH, Defendant-Appellant.	Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

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IT IS ORDERED by the Court that the petition for rehearing filed in this appeal be and the same is hereby denied.